Supreme Court, U.S.
FILED
JAN 20 1983
STEVAS
CLERK

No. 82-868

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For A Writ Of Certiorari To
The United States Court Of Appeals
For The Eighth Circuit

REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

CLAUDE HANKS, ESQ.
MB #16030
725 Old Ballas
Foreway Building
Creve Coeur, Missouri 63141
Tele: (314) 432-1170
Attorney for Petitioner

Of Counsel for Petitioner
LEONARD R. YOCUM, ESQ.
MB #15444
725 Old Ballas
Foreway Building
Creve Coeur, Missouri 63141
Tele: (314) 567-1424

St. Louis Law Printing Co., Inc., 411 No. Tenth Street 63101 314-231-4477

TABLE OF AUTHORITIES

Page

Cases

Calavo v. Commissioner, 304 F 2d 650 3,4

Caldwell v. Commissioner, 202 F 2d 112..... 4

Ezo Products Co., 37 T.C. 385 3

Glenn v. Kentucky Color and Chemical Co., Inc., 186 F 2d 975 3

Thor Power Tool Co. v. Commissioner, 439 US 522.... 3,4

Statutes and Regulations

IRC Section 446 (b) and (c)..... 5

Reg. 1-446-1 (b) 3,5

Reg. 1-446-1 (c) (2) (i) 3,5

No. 82-868

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For A Writ Of Certiorari To
The United States Court Of Appeals
For The Eighth Circuit

REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

Petitioner points out that Respondent's statement of the facts, in part, is erroneous. Respondent has misstated one of the issues to be that the Commissioner correctly accrued income due for goods shipped on a "sale or return" basis (Resp.-1). The real issue in this Petition for Writ of Certiorari (other than the bad debt issue) is whether the Commissioner properly changed the Petitioner from a cash basis (hybrid) taxpayer to an accrual basis taxpayer without first finding that the taxpayer's hybrid method did not clearly reflect income. Further, in alleging facts, Respondent has indulged in argument on page 2 of his brief by concluding as a fact that Petitioner "expensed each lot of merchandise by removing it from inventory at the time the lot was shipped." There is no such evidence in the transcript of proceedings. Again, in the last sentence of the middle paragraph

on page 2, Respondent uses argument as a statement of fact when referring to consignment transactions. As a matter of fact, the inventory value was negligible compared to selling price, and if those cost values were omitted (and Petitioner does not admit that they were), a proper method of treatment would be to add those cost values to inventory to be in accord with Petitioner's hybrid method of accounting. However, the Commissioner never attacked Petitioner's treatment of such in the trial of the case in the Tax Court, nor did the auditing agent bother to do so. She relied on the proposition that Petitioner used inventories and, therefore, was required to use an accrual method of accounting. She did not bother to investigate the propriety of Petitioner's method to see if such method did or did not clearly reflect income.

Petitioner has never seen fit to argue that its method of operations had to be categorized as a "sale or return" or as a "consignment." These categorizations were first raised in the brief filed by Respondent in the Tax Court. No such issue was raised at audit time nor at trial in the Tax Court. It has been Petitioner's argument all along that these categorizations and their meaning have been developed in the field of commercial law in deciding issues of creditors' rights and do not apply to situations determinative of whether a taxpayer's accounting method clearly reflects income.

Respondent's argument in opposition (Resp.-3) cites 26 C.F.R.1. 446-1 (c) (2) (i) as justification for the Commissioner's action. As argued in our Petition for this Writ, that section of the regulations is subordinate to 446-1 (b), which requires the Commissioner to first find that Petitioner's method of accounting did not clearly reflect income. Respondent has based his whole case from the audit, through the Tax Court and through the Court of Appeals, on the singular proposition that Petitioner used inventories, therefore, Petitioner was mandated to use an accrual method of accounting.

We do not quarrel with Respondent's argument (Resp.-3) that the Commissioner has broad power to determine whether a taxpayer's method clearly reflects income. Respondent cites *Thor* in support of that proposition. However, in *Thor,* that taxpayer was already on the accrual method of accounting. The taxpayer had marked down its inventories in a manner contrary to the regulations and to standard accounting practice. *Thor* decided individual accounting transactions within the framework of a method of accounting that was, admittedly, an accrual method. Here, we have a hybrid method of accounting that has been changed to a strict accrual method by the Commissioner.

Respondent's argument at the bottom of page 3 and at the top of page 4 of his brief suggests that there is no burden at all on the Commissioner to first find that Petitioner's method did not clearly reflect income. As we interpret the regulations and the case law cited in our petition, the shifting of any bruden to the petitioner could only occur after the Commissioner had found that petitioner's accounting method did not clearly reflect income. *Reg. 1-446-1 (b). Glenn and Ezo, supra* (Petition-p.11). Here, as in the Tax Court and the Court of Appeals, Respondent has avoided the real issue in this case, which is the interpretations of Reg. 1-446-1 (b) and its conflict with Reg. 1-446-1 (c) (2) (i). Those subsections are not consistent with one another except as suggested by Petitioner that the latter refers to a voluntary change in accounting methods initiated by the taxpayer. (Petitioner's brief - page 14). If it does refer to voluntary changes by the taxpayer, then it is consistent with 1-446-1 (b). If it doesn't, there is no consistency in the two subsections, and this Court should resolve the inconsistency.

In reply to Point 2 of Respondent's argument that Petitioner has not shown that the Commissioner has abused his discretion in disallowing a deduction for the partial worthlessness of the Sound-On debt, we re-emphasize *Calavo, supra,* cited on page 17 of this Petition. *Calavo,* of course, was cited with approval in

Thor. Although the 9th Circuit in *Calavo* used the words "His discretion has thus been exercised under a misapprehension as to the circumstances affecting the Duarte account", there can be no argument but that the Commissioner was being politely told that he abused his discretion. The 9th Circuit then told the Commissioner to go back and re-exercise his discretion upon the question of the Duarte account. As in *Calavo* (at 655), the Commissioner has, in disallowing any addition to a reserve for bad debts, refused to give any consideration whatsoever to the circumstances affecting the Sound-On account. He has disregarded the severe financial setback that occurred to Sound-On in 1974. By ignoring that substantial debt, and placing Petitioner on an accrual method of accounting, he has, in effect, increased Petitioner's income in 1974 by approximately $176,000.00, and has not allowed even $1.00 as a bad debt offset to this increase. What else does Petitioner or any other taxpayer have to do to prove an abuse of discretion?

The last part of Respondent's argument refers to *Caldwell, supra,* cited by Petitioner. Respondent has ignored that part of Petitioner's argument on the standard accounting practice of a reasonable allowance for a deduction for a bad debt reserve for the debt of Sound-On. For some reason, the Respondent refers to the fact that the court in *Caldwell* would not include as income, in the tax year in question, those parts of accounts receivable that represented sales in a prior tax year. That part of *Caldwell* has nothing to do with the fact situation in our case. Our reference in our argument was to that part of the opinion (at page 116 - headnote 8) relating to the bad debt issue decided in *Caldwell.* The only reference Respondent has raised in opposition to our Petition is his footnote 1, in which he abstractly suggests that *Caldwell* has been "legislatively overruled" by the enactment of IRC Section 481. Section 481 is a lengthy provision of the code including many paragraphs and subparagraphs. Petitioner can find no specific relevance to any part of the bad debt issue before this court. In reality, Petitioner's argument is based upon equity and fair play. The *Caldwell* decision does nothing more than emphasize those principles of equity and fair play.

CONCLUSION

Respondent's reply in opposition offers nothing in opposition to the issues presented by Petitioner's application for a Writ of Certiorari. Respondents have not addressed the issues presented. This Court should hear this Petition and decide that sub-paragraphs (b) and (c) of IRC Section 446, and the regulations thereunder, are inconsistent with each other and that Section 1-446-1 (c) (2) (i) is subordinate to the provisions of Section 1-446-1 (b). In the alternative, the decision of the Eighth Circuit Court of Appeals, on the bad debt issue, conflicts with the decisions of the Second and Ninth Circuits in this regard, and the Writ should issue for these reasons.

Respectfully submitted,

CLAUDE HANKS, ESQ. MB#16030
725 Old Ballas, Foreway Bldg.
Creve Coeur, MO 63141
Telephone: (314) 432-1170
Attorney for Petitioner

Of Counsel for Petitioner
LEONARD R. YOCUM, ESQ. MB#15444
725 Old Ballas, Foreway Bldg.
Creve Coeur, MO 63141
Telephone: (314) 432-1170

CERTIFICATE OF SERVICE

I do hereby certify that three true and correct copies of the foregoing were mailed, postage prepaid, to: Mr. John F. Murray, Acting Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20520; and Mr. Jerome D. Sebastian, acting Chief Counsel, Internal Revenue Service, Washington, D.C. 20530; and The Honorable Rex E. Lee, Solicitor General of the United States, Washington, D.C. 20530; by placing same in envelopes so addressed and depositing same in U.S. First Class mail, on this 20th day of January, 1983.

CLAUDE HANKS